CARE Ratings

Sweetness still eludes the sugar sector in India

Credit outlook for the sector continues to remain stressed

Sugar industry is the second largest agro-based industry after textiles in India and provides livelihood to over 50 million farmers and their families. Spread across the rural heartland, it has been contributing directly to the economic sustenance and development of the rural population, however, its own economic sustenance at present is very precarious with most sugar companies reeling under huge debt levels and mounting losses.

Decontrol of the sugar sector

The government has been trying to bring in reforms in the sector for a very long time and had setup various committees in the past to suggest ways to improve the fortunes of the sector. The most recent report was submitted by Dr Chakravarthi Rangarajan, Chairman of the Prime Minister’s Economic Advisory Council, in October 2012. It suggested various path-breaking measures to enhance the efficiency and growth of the sector. Taking cues from the same, the government has partially relaxed control over the sugar sector by lifting the levy obligation of 10% and abolishment of the regulated release mechanism. This means there will be no obligation for the sugar companies to sell 10% of their production at cheaper rates in order to cross-subsidize PDS sugar consumers. Furthermore, the sugar companies will be free to sell their entire production as per the market demand supply scenario. The sugar industry will surely benefit from these twin measures and is expected to reduce its losses by around Rs.3000 crore on lifting of levy obligation alone.

Although, abolishing the regulated release mechanism has resulted in a steady decline in the prices in the short run as a lot of sugar companies, who are facing pressure on account of mounting cane arrears or redemption of their debt obligations, are offloading their stocks. This, however, is expected to change once the festive season begins in October.

However, as Ms Swati Agarwal, CGM & Regional Head North, CARE says, “the partial deregulation is only one of the many steps required to enhance the viability of the sector and this limited relief will not be able to cure the misery of the sugar sector which continues to reel under heavy debts and losses.”

Fig 1 - Sugar M- Grade prices at Kolhapur during Sept 3, 2012 to Aug 28, 2013 (Source: NCDEX)

The total sugar production in the country is expected to be around 25 million tonnes during the Sugar Season (refers to the period October 1 to September 30; SS) 2012-13 as against the demand of 22.5 million tonnes. India is presently witnessing a surplus situation, which is further accentuated by an opening stock of 7 million tonnes of sugar which has also resulted in the subdued domestic sugar prices. Moreover, the surplus sugar stocks cannot be exported out of the country as the sugar prices in the global markets are trading at their lowest levels in three years.

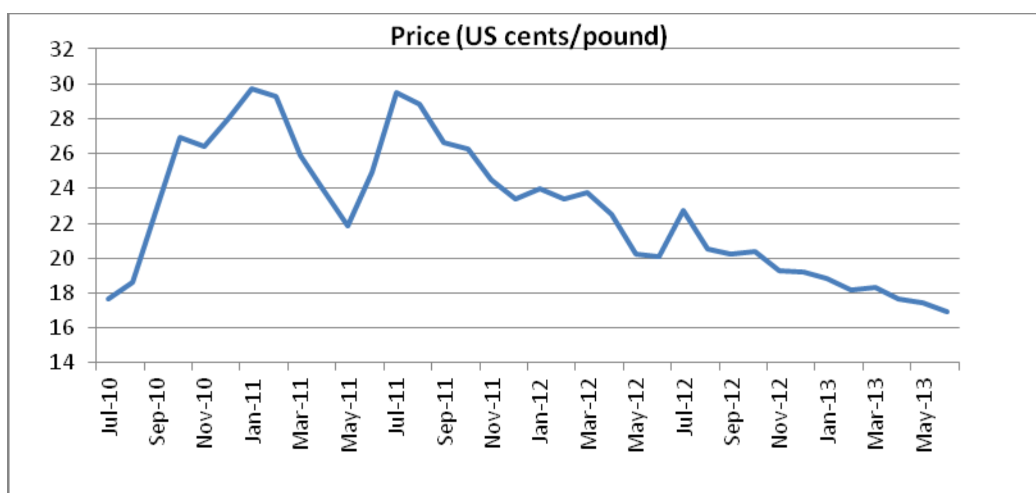

Fig 2 - Monthly Sugar Prices (Source: World Bank)

On account of bumper crop production, the global sugar prices have softened and cheap imports into India are also hurting the realizations of the local sugar manufacturers. The depreciation of rupee although has made imports relatively more expensive, the corresponding depreciation in other currencies primarily

Brazilian *Real* with respect to the USD has partially negated the positive impact of rupee depreciation for the local manufacturers. On July 9, 2013, the government increased the import duty on sugar to 15% from 10%; however the move fell short of industry expectations of increasing import duty to 30-40%.

Evolution of sugarcane pricing mechanism

The operating environment for the sugar companies is still not encouraging on account of a number of controls, and the most prominent one being the fixation of State Advised Prices (SAP) for the procurement of sugarcane by the state governments in their respective states. The SAPs fixed by the governments of various sugarcane producing states are deeply influenced by socio-political factors. There are no transparent criteria for fixing these prices and there is no linkage between the input and output prices.

Moreover, India has one of the lowest yield and recovery rates amongst the key sugar manufacturing nations. Stress should be laid on increasing the sucrose content as the same could significantly improve the input-output ratio and consequently realizations of the sugar companies. Along with a comparatively lower yield, India also has an average recovery rate of around 10% as compared with around 13% to 14% recovery rate in Brazil.

One of the important recommendations of the C Rangarajan Committee was in regard to revising the existing arrangement of cane payment to the farmers, whereby, the SAP fixed by the states should be dispensed with, and Fair and Remunerative Price (FRP) set by the Centre should be paid as the minimum price. Later, on a half-yearly basis, the state government concerned would announce the ex-mill prices of sugar and its by-products; and farmers would be entitled to a 70% share in the value of sugar and its by-products produced from the quantity of cane supplied by each farmer.

In all the major sugar producing nations in the world like Brazil, Australia and Thailand, there is a direct linkage between sugarcane and the sugar prices. Sugarcane grower’s revenue share in the total industry revenue is 62-67% in Australia; 56-61% in Brazil and 70% plus in Thailand.

The state government of Karnataka has taken a progressive step in this direction, and in May 2013, enacted the “Karnataka Sugarcane (Purchase and Supply Control) Act 2013”. Under the act, the government proposes to establish a Sugarcane Control Board comprising of ministers, bureaucrats, sugarcane growers and factory owners. The act mandates sharing of 70% revenue with the sugarcane growers in case of standalone sugar companies and 75% of the revenue in case of integrated sugar companies. The government of Maharashtra

has also proposed to bring in a new law for the purchase and supply of sugar on the lines of the Karnataka act. These are positive signs and there is a need for other major sugar producing states to move in this direction.

"At this point of time, India cannot afford to follow a different path and there is a pressing need for establishing a direct linkage between the price of sugarcane and sugar homogeneously across all the sugarcane producing states" says Ms Agarwal.

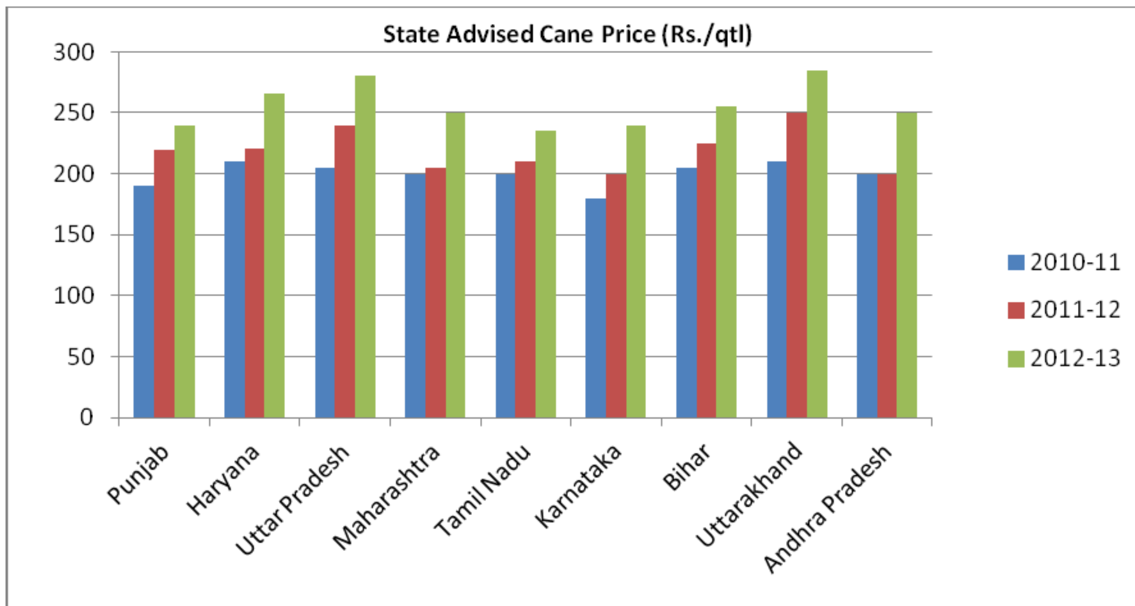

Fig 3 – State advised sugarcane prices (Source: ISMA)

Integrated Players also feeling the heat

With the sugar divisions of a majority of companies remaining under pressure, it is clear that only the players with integrated operations, ie, the companies operating co-generation power units and ethanol would be able to survive the current setup. However, in one of the largest sugar producing states, UP, even the integrated players are facing problems as there are huge delays in realizations for power supplied to Uttar Pradesh Power Corporation Limited (UPPCL), which owes around Rs.500 crore to the sugar industry towards the power supplied through co-generation. The same has resulted in a stressed liquidity position of the sugar mills and they are unable to pay off the cane arrears. At the end of June 2013, the cane arrears stood at approximately Rs.5,821 crore in India, out of which the share of UP alone stood at approximately Rs.4,235 crore.

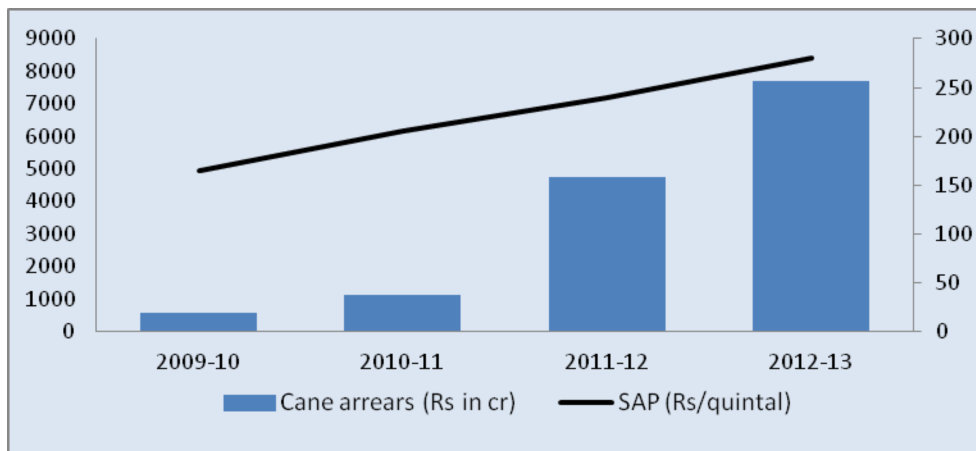

Fig 4 - With the hike in SAP in UP, the cane arrears have increased to record high levels

In addition to the delay in recovery of dues from the power companies, the problems of integrated mills are accentuated by the restrictions on the production of Ethanol. In India, Ethanol cannot be produced directly from sugarcane and can only be produced from molasses, a by-product of sugar. However, in other countries like Brazil, mills are free to manufacture either ethanol or sugar from sugarcane. Presently, the fuel sold at Brazilian service stations is E20; implying 20% of ethanol is blended with the fuel.

Ethanol blending in the fuel reduces greenhouse gas emissions and reduces the dependency on fuel imports. India imports more than 70% of its crude oil requirements which has an adverse impact on its Current Account Deficit (CAD), which reached 4.8% of GDP in 2012-13 on account of the high oil imports and slowdown in exports. The complete deregulation of the sugar industry will help in the increased production of Ethanol. In October 2007, ethanol blending of 5% in fuel was made mandatory. India has a target of E20 by 2017 year end. However, inadequate availability of ethanol poses a major road block to the blending programme.

Credit Perspective

From a credit perspective, CARE analyses the impact of changes in the Fair and Remunerative Prices & State Advised Prices, sugarcane production trends in view of variation in acreage and dependence on monsoons, recovery rates, realizations of dues of integrated players from the power distribution companies, status of cane arrears, global demand-supply scenario and exchange rate fluctuation which may lead to import substitution of the local produce.

Furthermore, the short-term and long-term impact of regulatory decisions which affect both the supply-side and the demand-side dynamics of the industry on the company's financials are analyzed. These factors help to identify the determinants and ascertain the liquidity profile of a company, and consequently its ability to repay debt obligations as and when they are due.

CARE has observed that socio-political factors influence the determination of the State Advised Prices, which are in significant variation with the Fair and Remunerative Prices recommended by the Central Government. The diminution or rather lack of economic rationale in setting SAP has lead to a situation, wherein a non-integrated sugar manufacturing facility is not viable on its own. This has also eroded the competitiveness of the domestic sugar manufacturing industry vis-à-vis their global peers, most of which follow a revenue share-based sugar cane pricing system.

Outlook

During the current sugar season, the sugar companies again witnessed a spike in the State Advised Prices. With a high domestic opening balance of around 7 million tonnes for the 2012-13 season and a bumper crop in other sugar exporting countries, the prices of sugar are expected to remain subdued. In addition, the discontinuation of the levy quota has also lead to inflow of a high quantity of stock in the market which has put downward pressure on the sugar prices in the short-term. The integrated sugar manufacturers are expected to have better liquidity profile as compared with standalone sugar manufacturers; however, CARE believes that with the current sugarcane pricing policy and global demand-supply scenario, the profitability margins and liquidity profile of the sugar companies will continue to remain stressed.

However, with some states deciding to implement pragmatic policy measures and trying to achieve the right balance between the interests of various stakeholders, the sugar industry may witness stability in the costs and price realisations which are expected to improve the liquidity going ahead.

Rating Dispersion of CARE Rated Sugar Companies

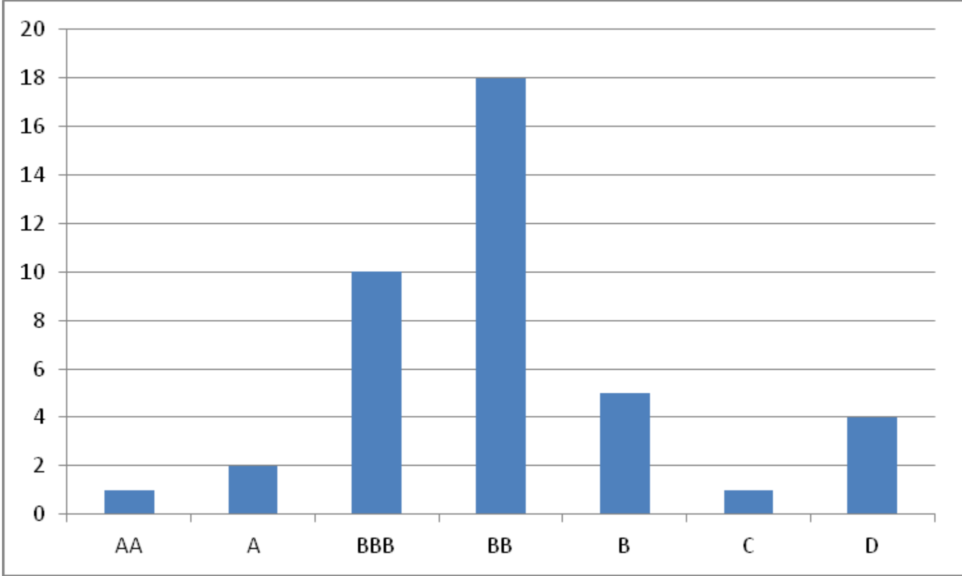

Fig 5 – Outstanding ratings of 41 CARE rated sugar companies as on September 01, 2013

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